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Business strategy, overvalued equities, and stock price crash risk

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ABSTRACT

This paper examines empirically the effect of firm-level business strategies on future stock price crash risk, and the extent to which equity overvaluation moderates this relation. By exploring the extent to which firms following particular business strategies are more or less likely to experience crash risk, we provide evidence that increases our understanding of the underlying determinants of crash risk. Using a composite strategy score developed by Bentley, Omer and Sharp (2013) and applying two variants of crash risk, we document that firms following innovative business strategies (prospectors) are more prone to future crash risk than defenders. We also find that prospectors are more prone to equity overvaluation which, in turn, increases future crash risk.

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1. Introduction

This paper investigates whether firm-level business strategies affect future stock price crash risk. We also test for whether equity overvaluation moderates the association between the two. By exploring the extent to which firms following particular business strategies are more or less likely to experience crash risk, we provide evidence that increases our understanding of the underlying determinants of crash risk and thus help investors in allocating funds to less risky businesses. Interest in investors' perceptions of crash risk has been increasing, particularly since the 2008 financial crisis. In the advent of the crisis, investors' lack of confidence and fear of further decreases (crash risk) in prices have been identified among the various culprits behind the dramatic price declines. Thus, understanding what affects investors' perceived crash risk warrants our research. Crash risk is a vital element in stock returns to investors because, unlike risks emanating from systematic volatilities, it cannot be diversified away (Sunder, 2010).

The extant literature on the underlying reason for crash risk is dominated by the 'bad news hoarding' theory, which argues that managerial incentives for withholding bad news for an extended period increases the probability of crash risk. When the accumulation of bad news passes a threshold, it is revealed to the market at once, leading to a large negative drop in price for

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